No. 13773

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

HOWARD BEST,

Appellant,

vs.

HENRY A. POWIS, JEANNETTE M. REYNOLDS, as Administratrix with the Will Annexed of the Estate of HARRY V. REYNOLDS, substituted in the place and stead of HARRY V. REYNOLDS, and A. E. TIERNEY,

Appellees.

APPELLANT'S OPENING BRIEF.

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Statement of Jurisdiction of District Court.

I.

The District Court had jurisdiction below under the provisions of 28 U. S. Code, Section 1332 which provides:

> "Diversity of Citizenship; amount in controversy. (a) The District Courts shall have original jurisdiction in all civil actions where the matter in controversy exceeds the sum in value of $3,000.00 exclusive of interest and cost and is between: [sub. 1] Citizens of different states * * *."

It appears from the Second Amended Complaint [R. 3] that:

1. Plaintiff is a citizen of the State of Utah.

2. All of the defendants are citizens of the State of California.

3. The amount in controversy [R. 4] exclusive of interest and costs exceeds the sum of $3,000.00. The amount actually involved is $10,000.00 [R. 5, 7, 17].

Statement of Appellate Jurisdiction Under Rule 20(b).

Jurisdiction of this Court is grounded on United States Code, Title 28, Section 1291 as follows:

> *"Final decisions of District Courts.* The Courts of Appeal shall have jurisdiction of appeals from all final decisions of the District Courts of the United States * * *, except where a direct review may be had in the Supreme Court."

The appeal herein is from a final order dismissing the action [R. 60]. The order dismissing was docketed and entered on 29 January, 1953 [R. 59]. The notice of appeal was filed 27 February, 1953 [R. 60].

Abstract of the Case.

The case sounds in fraud for the selling to the plaintiff of corporate stock in violation of the California Corporate Securities Law, the "Blue Sky Law" (Cal. Corp. Code, Secs. 25000 to 26000, incl.). The action was dismissed by the Court below wholly upon the ground "that the alleged cause of action is barred by the Statute of Limitations" [R. 58].

Specifications of Error.

I.

The Court erred in holding that the plaintiff actually discovered the fraud within three years, after the fraud was committed, contrary to the direct allegations of the complaint.

II.

The Court erred in making a finding of fact contrary to the pleaded facts, wherein the Court stated [R. 56]:

> "Upon the facts of the case, the plaintiff did not act with due diligence or, *as seems more likely, he actually discovered the facts and decided for some undisclosed reason not to act thereon.*" (Emphasis added.)

III.

The Court erred in holding that the plaintiff was constructively charged with knowledge of facts constituting the fraud before his actual discovery thereof.

ARGUMENT.

Summary.

Point I. Since the Court below decided the case entirely upon the allegations of the Second Amended Complaint [R. 57-58] it had no power to find facts contrary to those allegations [R. 54-57].

Authorities:

A motion to dismiss a complaint for insufficiency supplants the general demurrer and admits, for the purposes of the motion, all facts which are well pleaded, and the complaint must be construed in the light most favorable to the plaintiff.

Cohen v. United States (C. C. A. 8), 129 F. 2d 733;

Galbreath v. Metro Trust Co. (C. C. A. 10), 134 F. 2d 569;

Carroll v. Morrison Hotel Corp. (C. C. A. 7), 149 F. 2d 404;

Dennis v. Tonka Bay (C. C. A. 8), 151 F. 24 411.

Point II. The bar of the Statute of Limitations was improperly applied in consideration of all of the facts pleaded by plaintiff.

Authorities:

Hobart v. Hobart Estate Co., 26 Cal. 2d 412, 436-440, 159 P. 2d 958;

Lady Washington C. Co. v. Wood, 113 Cal. 482, 45 Pac. 809;

Consol. R. & P. Co. v. Scarborough, 216 Cal. 698, 16 P. 2d 268;

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Edwards v. Sergi, 137 Cal. App. 369, 30 P. 2d 541;

Smith v. Martin, 135 Cal. 247, 67 Pac. 779.

POINT I.

Under our Point I above we have urged that since the Court decided the case entirely upon the allegations of the Second Amended Complaint [R. 57-58] it had no power to find facts contrary to those allegations [R. 54-57]. The Memorandum of the Decision of the lower court on motion to dismiss Second Amended Complaint after discussing some of the pleadings etc. and after some discussion of the law, says: "Upon the facts of the case, the plaintitff did not act with due diligence or, as seems more likely, he actually discovered the fact and decided for some undisclosed reason not to act thereon" [R. 56]. Here the Court has made a statement, a finding of fact, at complete variance with the allegations of the complaint, *i. e.,* the Second Amended Complaint, herein referred to as the complaint for brevity. The lower court has lightly set aside every allegation in the complaint concerning the plaintiff's activities, and his stated reasons for not having discovered the fraud which had been practiced upon him within the prescribed three year period. We do not wish to belabor the Court with matter quoted from the record. However, plaintiff [R. 10] states: "That all times herein mentioned until September, 1951, plaintiff was wholly unaware of the fraud and deception practiced by the living defendants * * *, or of the invalidity of said sale and issuance to him of 10,000 shares of the stock. * * * Plaintiff first learned of such fraud, deceit and invalidity under the following circumstances."

Here follows a narration that plaintiff became sales representative of the company for California [R. 10-11]. He necessarily traveled continuously about the state and much of his time was spent in traveling. During this time he had no access and no right of access to the books [R. 11] (the stock was not issued to him until December 23, 1947); during the Fall of 1947, the plaintiff worked in the factory of the corporation [R. 11]. Thereafter he returned to his sales representative position, and again spent his time outside the plant and outside the office of the corporation. On January 6, 1948, he was elected a director [R. 11], *but still retained his position as sales representative and continued to travel* [R. 11-12]. He was outside the office during his work, and business time [R. 12]. Until the 16th of February, 1948, he never saw the minutes other than certain stockholders minutes of January 6, 1948 [R. 12]. The By-laws provided for monthly meetings [R. 12]. Upon 15 January, 1948, no quorum appeared for the directors meeting. On 16 February, 1948, plaintiff was elected and qualified as secretary-treasurer [R. 12]. Plaintiff was entitled to custody of all the books and records of the corporation thereafter but in fact said books and records were kept at the office of the corporation, and plaintiff did not ever see those books, records and documents of the corporation pertaining to the application for said permit to issue stock filed in the summer of 1947, nor the said permit to issue stock which was issued upon September 4, 1947; and did not in fact know of the terms of said permit nor of the

whereabouts of said documents [R. 12]. Generally during this period the plaintiff was outside the office of the corporation [R. 13]. His secretary-treasurer duties consisted of slight administerial assistance for the active management and required only a small part of his time [R. 13]. At no time did he see any of the records and did not know of their whereabouts or of their existence [R. 13]. The defendants actually concealed from the plaintiff the facts herein alleged with reference to the issuance of said stock to plaintiff and that the issuance of the same did not comply with said permit to issue stock dated September, 1947 [R. 13]. From January, 1948, to and including November, 1948, the situation continued to exist whereby plaintiff was a director secretary-treasurer *and at the same time was sales representative and engaged outside of the office of the corporation in doing his best to promote sales and to put said corporation back on its financial feet.* In December of 1947, plaintiff learned of the precarious financial condition of the corporation during that month [R. 13] and would not then have invested and believed that he had bought his stock in June of 1947 [R. 13-14].

Plaintiff spent his best efforts and all of his working and business time attempting to restore said corporation to a sound, financial position and paid no attention whatsoever to his own personal rights or to the condition surrounding the issuance of said stock or the granting of said permit.

The monthly meetings of the directors are set forth and the subject matter discussed at each meeting is set forth [R. 14-15].

It should be noted that on November 2, 1948, at a special meeting of the Board of Directors [R. 15] a resolution was passed wherein the *president* of the corporation was authorized either to sell all the assets of the corporation or to file a voluntary petition in bankruptcy [R. 15].

On November 15, 1948, at a regular meeting of the board it was resolved that Howard Best as *secretary* of the corporation should be authorized to file a voluntary petition in bankruptcy in the United States District Court.

At no time during any of said meetings were the facts surrounding the issuance of plaintiff's stock ever mentioned, and plaintiff believes that this was part of a purposeful concealment whereby plaintiff was prevented by the living defendants and said Reynolds from learning said facts.

On 15th of November, 1948, *for the first time*, plaintiff took actual possession of the books, records and documents of said corporation and handed them to the attorney for the corporation for the purposes of preparing a voluntary petition in bankruptcy. Petition in bankruptcy was filed. Receiver was appointed; a trustee was appointed. All the books, records and documents were handed to the

receiver [R. 16]. Trustee in bankruptcy retained possession thereof until August, 1951 [R. 16].

Thus from the foregoing (which the lower court should have accepted as true under the well established rules, it is, we submit, well pleaded that the plaintiff did *not* have actual knowledge of the facts surrounding the issuance of the permit to issue stock of September, 1947.

Yet the Court below has set all this aside, has paid no attention to it, and has stated that "or as seems more likely, he actually discovered the facts and decided for some undisclosed reason not to act thereon" [R. 56].

This ruling was made entirely upon the motion to dismiss and in the same memorandum decision the Court denied the motion for summary judgment as moot, and the motion to strike was ordered off calendar [R. 57].

The rule applicable is that a motion to dismiss a complaint for insufficiency supplants the common law and code pleading general demurrer and admits for the purposes of the motion the trust of all facts which are well pleaded, and the complaint must be construed in the light most favorable to the plaintiff. Upon this point we respectfully refer the Court to the cases listed above under our Point I and respectfully submit that the Court did not either consider as true all of the well pleaded facts or construe the complaint in the light most favorable to the plaintiff. This second concept, of course, shades over into our Point II.

POINT II.

Under this we have above cited a number of authorities.

The fraud alleged occurred in 1947. The final act consummating the fraud, in December, 1947, was the issuance and delivery to plaintiff of the certificate for 10,000 shares of stock. Antedating this for many months were the representations of the defendants from before 17 June, 1947, to induce plaintiff to part with his money. Before this also was the issuance of the *note* in June, and the June, 1947 application for the permit to issue stock—permit granted 4 September, 1947—and all ultimately ended by the issuance of the stock to the plaintiff for the cancellation of the note—NOT for cash as required by the permit.

The action was not commenced until October 24, 1951, three years and ten months after the actual consummation of the fraud alleged.

The lower court decided the case solely on the basis of the California Statute of Limitations.

California Code of Civil Procedure, Section 338, provides actions for fraud must be brought within three years of discovery of the "fact constituting the fraud."

After three years, the time of discovery must be alleged and affirmatively proved by the plaintiff. With that proposition there is no argument. In this case in compliance of that requirement of the law, the complaint states many facts (some hereafter quoted), concerning the

reasons for plaintiff's failure to discover the issuance of the September, 1947 permit within the three years:

> [R. 6]: "* * * the living defendants and said Reynolds concealed and suppressed from plaintiff the condition imposed by the terms of the permit of December 17, 1946, as hereinabove alleged, and the fact that said sale of June 17, 1947, was in violation of said condition."
>
> [R. 6]: "As a subterfuge and scheme and in order to avoid the disclosure in the records of the Reypo Corporation of a sale in violation of the condition imposed as aforesaid in the permit of December 17, 1946, the living defendants and said Reynolds at the time of said sale to plaintiff, withheld issuing a share of certificate reflecting his ownership of 10,000 shares of Reypo Corporation, and instead delivered him a document purporting to be the promissory note of said corporation in the sum of $10,000.00, providing for payment after thirty days with interest at 6% per annum and caused the Reypo Corporation to reflect said sale to plaintiff on its records as a loan by plaintiff to said corporation upon the terms of said purported promissory note."
>
> [R. 7]: "Plaintiff accepted this purported promissory note in good faith, without knowing that the * * * defendants were using it as a subterfuge and scheme * * * and in the belief that the delay in issuing a share certificate to him was due to some technical corporate requirement with which plaintiff was unfamiliar. At the time of said sale plaintiff had recently become a resident of the State of California, and had no knowledge of the Corporate Securities Act of said state, the regulations promulgated thereunder or the requirements in Cali-

fornia concerning the issuance of a certificate reflecting stock ownership in a corporation."

[R. 8]: "In June, the defendants caused the corporation to apply for a new permit [R. 8]. This was granted in September [R. 9, 10] and permitted only sales for *cash.*"

[R. 8]: "on or about December 23, 1947, the * * * defendants * * * caused the Corporation to issue to plaintiff its share certificate No. 63 reflecting ownership in plaintiff of 10,000 shares of stock of said corporation, and as the sole consideration therefore demanded and received from the plaintiff the return and cancellation of the purported promissory note executed as aforesaid."

[R. 8-9]: "In so doing the living defendants and said Reynolds suppressed and concealed from plaintiff, and until September, 1951, he was unaware of the fact of such application for a new permit and the existence, terms and conditions of said permit of September 4, 1947, and particularly the fact that a permit had been obtained after said sale of shares to plaintiff which affected said sale and which required that any sale or issuance of shares pursuant to such permit be made at par for cash in such manner that Reypo Corporation would net the full amount of the selling price of said shares."

Plaintiff recites that he first learned of such fraud, deceit and invalidity under the following circumstances: [R. 10 *et seq.*]. In July of 1947 plaintiff was appointed and actively entered upon his duties as sales representative of Reypo Corporation for the entire territory of the State of California. During the course of his duties in such position he necessarily had to and did

travel continuously, around and about the State of California and a great portion of his time was spent in so traveling. During this period he had no access and no right to the access to the books and records either of account or of the internal structure of the Reypo Corporation. During the Fall of the year 1947, the plaintiff, due to production difficulties encountered by the Reypo Corporation (which was in the business of manufacturing small sets of precision machine tools such as drill presses etc.) spent his daily work time in the factory of the Corporation and performed manual labor in actual production work in the plant of said corporation. During this time also he had no access and no right of access to the books and records of the corporation. The stock was issued to him as aforesaid on or about December 23, 1947. After the completion of his production work in said factory and after a return to normal production he again resumed his position and duties as sales representative in California and again his business and work time was consumed in being outside of the plant and outside of the office of the corporation.

Upon January 6, 1948, at a regular meeting of the stockholders of the corporation, the plaintiff was personally present and was elected a director of said corporation. At said time and thereafter he retained his position as sales representative and pursuant to the duties of said position continued to travel and to be outside of the office of the corporation during his said work and business time.

> "From January 6, to and including the 16th day of February, 1948, the plaintiff did not ever see any of the minutes of the corporation other than certain

minutes of the stockholders meeting of January 6, 1948, which was signed by him as acting secretary, after having been prepared in his absence by some person now unknown to plaintiff.

"That the By-Laws of the Reypo Corporation provided for regular meetings of the directors on the 15th days of each calendar month. That upon the 15th day of January, 1948, no quorum appeared at the scheduled regular meeting of the board of directors for that month and the plaintiff so certified in the minute book of the corporation. That on the 16th day of February, 1948, the plaintiff was duly elected and qualified as secretary-treasurer of said corporation and continued to hold said office thereafter.

"That as such secretary-treasurer of the corporation plaintiff was entitled to custody of all the books and records of the corporation but in fact said books and records were kept at the office of the corporation and plaintiff did not ever see those books, records and documents of the corporation pertaining to the application for said permit, to issue stock filed in the summer of 1947, nor the said permit to issue stock which was issued upon September 4, 1947, and did not in fact know of the terms of said permit or of the whereabouts of said document.

"That plaintiff was during all of this period attempting to sell the products of the corporation and was generally outside its office and his duties as secretary-treasurer, which consisted of slight assistance to the active management of the corporation required only a very small part of his time, and he at no time saw any of the aforesaid records and did not know of their whereabouts or of their existence. Plaintiff is informed and believes and therefore

alleges that he was elected a director of the corporation and became an appointed secretary-treasurer thereof among the others for the reason that he would thereby be sought to be charged with the knowledge of the corporate affairs to such an extent that the living defendants and said Reynolds might be exculpated from liability by such constructive knowledge and that they actually concealed from plaintiff the facts herein alleged with reference to the issuance of said stock to plaintiff and that the same did not comply with the said permit to issue stock of September, 1947.

"Thereafter during the months from January to and including November, 1948, the aforesaid situation existed, *i. e.,* plaintiff was a director and secretary of said corporation and at the same time was sales representative and engaged outside of the office of the corporation in doing his best to promote sales and to put said corporation upon its feet. Plaintiff had learned of the precarious financial condition of the corporation during or about December, 1947, and would not then have invested money and believed he had bought such stock in June, 1947 and plaintiff spent his best efforts and all of his working and business time in an attempt to restore said corporation to a sound and financial position and paid no attention whatsoever to his own personal rights, or to the conditions surrounding the issuance of said stock or the granting of said permit.

"During the months of January to and including November, 1948, as aforesaid, the following meetings of the board of directors were held, at which plaintiff was present and at which only the following things, matters and proceedings were in general discussed."

(Summarized not quoted):

February 16, 1948, regular meeting, plaintiff elected secretary-treasurer, and general discussion was held of the condition of the business.

March 15, 1948, regular meeting, during which a discussion was held concerning the inadequacy of quarters at 1233 Lincoln Blvd., Santa Monica, Calif., and new quarters were decided upon.

May 20, 1948, special meeting, during which the condition of the company was stated to the board of directors as being very precarious and general discussions were held concerning financing and the conduct of the business in the future.

July 15, 1948, regular meeting, during which discussion was had only as to the bad financial shape of the company and plans were considered to get more money into the company, if possible, and for the general management of the company [R. 10].

September 30, 1948, special meeting of stockholders for the purpose of establishing the present and future policies of the corporation and to discuss and determine the advisability of offering for sale the complete development, including engineering patterns, prototypes, etc., of the production of the corporation, etc.

October 6, 1948, reconvened stockholders meeting for the further discussion of previous matters set forth at the prior meeting and to receive the report of the committee appointed by the stockholders at that meeting to investigate solutions for the company's situation and "Section 11."

October 11, 1948, reconvened meeting of the shareholders of September 30 and October 6, and a discussion of the possible course of bankruptcy.

November 2, 1948, special meeting of the Board of Directors wherein the president of the corporation was authorized either to sell all of the assets of the corporation to Marsden Associates or if unable to do so, to file a voluntary petition in bankruptcy.

November 15, 1948, regular meeting of the board of directors, at which time it was resolved that Howard Best, as secretary of the corporation (plaintiff herein) should be authorized to file a voluntary petition of bankruptcy in the above-entitled court.

That at no time during any of said meetings were the facts surrounding the issuance of plaintiff's stock ever mentioned, and plaintiff is informed and believes that this was a part of a purposeful concealment whereby plaintiff was prevented by the living defendants and said Reynolds from learning said facts.

That about said 15th day of November, 1948, for the first time, plaintiff took actual possession of all of the books, records and documents of and pertaining to said corporation and handed them to the attorney for the corporation for the purpose of preparing a voluntary petition in bankruptcy.

That thereafter and on or about the 18th day of November, 1948 [R. 11], the said Reypo Corporation did file its certain voluntary petition in bankruptcy in this court and was thereupon adjudicated a bankrupt, in bankruptcy matter numbered 46697 in the office of the clerk of this court.

That thereupon a receiver was appointed and thereafter a trustee was appointed. That immediately upon the appointment of said receiver, all of the books, records and documents of and pertaining to said corporation were handed to said receiver who thereafter had complete custody thereof, and thereafter said books, records and documents were handed to the trustee in bankruptcy. Said trustee in bankruptcy retained possession thereof until August, 1951, when, after completion of the entire bankruptcy proceedings with reference to said corporation, they were returned to plaintiff as secretary of said corporation. Plaintiff at no time hereinabove mentioned even suspected that his said stock had been issued to him in any way in violation of the terms of said permit of September 4, 1947, and did not have actual knowledge thereof until September, 1951, as hereinafter set forth.

In September, 1951, he contacted his present attorney of record to determine whether, under California law, corporate directors owed any duty to prospective purchasers of shares in a corporation to disclose fully to them the inadequate financial condition of the corporation before making any sale of shares to them, and, if so, whether under the facts and circumstances related by him to said attorney there was any breach of such duty on the part of the living defendants and said Reynolds which would give rise to a cause of action on his part against them; said attorney thereupon made an investigation of the affairs and records of the Reypo Corporation and, upon ascertaining the terms and conditions of said permits of December 17, 1946, and September 4, 1947, also examined the files and records of the California Commissioner of Corporations relating to said corporation; at

the conclusion of such investigation and examination, said [R. 12] attorney informed plaintiff, and plaintiff then learned for the first time, of the terms and conditions of said permits, of the requirements and provisions of the California Corporate Securities Act and the regulations promulgated thereunder, of the invalidity thereunder of said sale and issuance of shares to him, and of the fraud and deceit practiced upon him by the living defendants and said Reynolds, as aforesaid.

That, as aforesaid, plaintiff first obtained actual custody and possession of said books and records for a short period of time in November, 1948, and has commenced this action within three years thereafter.

The question is, therefore, whether plaintiff was negligent in not discovering the fraud sooner.

This question has been exhaustively considered by the Supreme Court of California in 1945 in the case of *Hobart v. Hobart Estate Co.*, 26 Cal. 2d 412, 436-444, 159 P. 2d 958, as follows:

II. *Statute of Limitations.*

> "Defendants contend that this action is barred by section 338 of the Code of Civil Procedure which provides a three-year period of limitations for commencement of: 'An action for relief on the ground of fraud or mistake. The cause of action in such case not to be deemed to have accrued until the discovery, by the aggrieved party, of the facts constituting the fraud or mistake.' The conferences at which Greene is claimed to have made false representations were held in the latter part of 1935, and the transaction based thereon was completed in January, 1936. The present action, however, was not

commenced until June, 1941, more than five years after the alleged fraud took place.

"The provision tolling operation of the statute until discovery of the fraud has long been treated as an exception and, accordingly, this court has held that if an action is brought more than three years after commission of the fraud, plaintiff has the burden of pleading and proving that he did not make the discovery until within three years prior to the filing of his complaint. (See Sublette v. Tinney (1858), 9 Cal. 423; Lady Washington C. Co. v. Wood, 113 Cal. 482 [45 P. 809]; Consolidated R. & P. Co. v. Scarborough, 216 Cal. 698 [16 P. 2d 268]; Knapp v. Knapp, 15 Cal. 2d 237, 242 [100 P. 2d 759].) Further, although negligence by the person defrauded is not a defense to a promptly brought action based upon intentional misrepresentation (see Seeger v. Odell, 18 Cal. 2d 409, 414 [115 P. 2d 977, 136 A. L. R. 1291]), the cases construing section 338, subdivision 4, *supra,* have held that plaintiff must affirmatively excuse his failure to discover the fraud within three years after it took place, by establishing facts showing that he was not negligent in failing to make the discovery sooner and that he had no actual or presumptive knowledge of facts sufficient to put him on inquiry. (See Johnson v. Ehrgott, 1 Cal. 2d 136, 137 [34 P. 2d 144]; Original Min. & Mill. Co. v. Casad, 210 Cal. 71, 74 [290 P. 456]; Del Campo v. Camarillo, 154 Cal. 647, 657 [98 P. 1049].)

"Defendants assert that in addition to these requirements plaintiff must show that he made a diligent inquiry to discover whether or not he had been defrauded, and they argue that plaintiff failed to prove that earlier inquiry would not have revealed the falsity of the alleged representations. It is not

in every case, however, that a person is barred after three years by failure to pursue an available means of discovering possible fraud. The statute commences to run only after one has knowledge of facts sufficient to make a reasonably prudent person suspicious of fraud, thus putting him on inquiry. Section 19 of the Civil Code provides: 'Every person who has actual notice of circumstances *sufficient to put a prudent man upon inquiry* as to a particular fact, has constructive notice of the fact itself in all cases in which, by prosecuting such inquiry, he might have learned such fact.' (Italics added.) Under this section it was held in Tarke v. Bingham, 123 Cal. 163 [55 P. 759], that the plaintiff was not barred by subdivision 4 of section 338 of the Code of Civil Procedure, since nothing had occurred 'to excite his suspicion, or to put him upon inquiry.' (123 Cal. at p. 166.) The court said: 'Where no duty is imposed by law upon a person to make inquiry, and where under the circumstances "a prudent man" would not be put upon inquiry, the mere fact that means of knowledge are open to a plaintiff, and he has not availed himself of them, does not debar him from relief when thereafter he shall make actual discovery. *The circumstances must be such that the inquiry becomes a duty, and the failure to make it a negligent omission.*' (Italics added.) Many other decisions have adopted this view. (See Mary Pickford Co. v. Bayly Bros., Inc., 12 Cal. 2d 501, 511 [86 P. 2d 102]; Original Min. & Mill. Co. v. Casad, 210 Cal. 71, 76 [290 P. 456]; Prewitt v. Sunnymead Orchard Co., 189 Cal. 723, 730 [209 P. 995]; Victor Oil Co. v. Drum, 184, Cal. 226, 241 [193 P. 243]; Lady Washington C. Co. v. Wood, 113 Cal. 482 [45 P. 809]; West v. Great Western Power Co., 36 Cal. App. 2d 403, 406, *et seq.* [97 P. 2d 1014]; Denson v.

Pressey, 13 Cal. App. 2d 472 [57 P. 2d 522]; Edwards v. Sergi, 137 Cal. App. 369 [30 P. 2d 541]; *cf.* Smith v. Martin, 135 Cal. 247, 254-255 [67 P. 779].) In many cases it has been said that means of knowledge are equivalent to knowledge. (See Shain v. Sresovich, 104 Cal. 402, 405 [38 P. 51]; People v. San Joaquin etc. Assn., 151 Cal. 797, 807 [91 P. 740]; Consolidated R. & P. Co. v. Scarborough, 216 Cal. 698, 701 et seq. [16 P. 2d 268]; Knapp v. Knapp, 15 Cal. 2d 237, 242 [100 P. 2d 759]; Bainbridge v. Stoner, 16 Cal. 2d 423, 430 [106 P. 2d 423]; Merrill v. Los Angeles Cotton Mills, Inc., 120 Cal. App. 149, 158 [7 P. 2d 329]; Daily Tel. Co. v. Long Beach Press Pub. Co., 133 Cal. App. 140, 143-147 [23 P. 2d 833]; Wheaton v. Nolan, 3 Cal. App. 2d 401, 403 [39 P. 2d 457]; Haley v. Santa Fe Land Imp. Co., 5 Cal. App. 2d 415, 420, 423 [42 P. 2d 1078]; Vertex Inv. Co. v. Schwabacher, 57 Cal. App. 2d 406, 415-418 [134 P. 2d 891]; Bryan v. Nicolas, 67 Cal. App. 2d 898 [155 P. 2d 835]; *cf.* Truett v. Onderdonk, 120 Cal. 581, 589 [53 P. 26]; Phelps v. Grady, 168 Cal. 73, 79-80 [141 P. 926]; Malone v. Clise, 18 Cal. App. 2d 154, 157 [63 P. 2d 321].) This is true, however, only where there is a duty to inquire, as where plaintiff is aware of facts which would make a reasonably prudent person suspicious. In the Lady Washington case, the court said (113 Cal. at p. 487) that 'as the means of knowledge are equivalent to knowledge, *if it appears that the plaintiff had notice or information of circumstances which would put him on an inquiry* which, if followed, would lead to knowledge, or that the facts were presumptively within his knowledge, he will be deemed to have had actual knowledge of these facts.' (Italics added.)

"The reason for the rule is well stated in Victor Oil Co. v. Drum, *supra* (184 Cal. at p. 241): 'The courts will not lightly seize upon some small circumstance to deny relief to a party plainly shown to have been actually defrauded against those who defrauded him on the ground, forsooth, that he did not discover the fact that he had been cheated as soon as he might have done. It is only where the party defrauded should plainly have discovered the fraud except for his own inexcusable inattention that he will be charged with a discovery in advance of actual knowledge on his part.' It follows that plaintiff is not barred because the means of discovery were available at an earlier date *provided* he has shown that he was not put on inquiry by any circumstances known to him or his agents at any time prior to the commencement of the three-year period ending June, 1941.

"The record in this case contains a most complete presentation of all relevant circumstances that might have a bearing upon this question up to and including the completion of the transaction in January, 1936. Most of these factors have been discussed heretofore in connection with the sufficiency of the evidence to establish a cause of action for fraud. The problems there considered, however, did not directly concern ordinary *negligence* by plaintiff, since this would not be a defense to an action based upon intentional misrepresentation. (See Seeger v. Odell, 18 Cal. 2d 409, 414 [115 P. 2d 977, 136 A. L. R. 1291].) Accordingly, we must now determine whether plaintiff has brought himself within the exception to the statute of limitations. Plaintiff's evidence, if believed, disclosed certain factors that may have tended to discourage the making of an

exhaustive independent investigation, and we cannot hold, as a matter of law, that any of the circumstances known to plaintiff should have put a reasonably prudent man upon inquiry. The jury could have found that Greene's representations were of such a nature as to lull plaintiff into a sense of security or state of inaction,—an important factor to be considered in determining whether or not plaintiff was negligent in failing to investigate. (See, for example, Denson v. Pressey, 13 Cal. App. 2d 472, 476 [57 P. 2d 522]; Edward v. Sergi, 137 Cal. App. 369 [30 P. 2d 541].)

"Another pertinent factor is that there was a fiduciary relationship between the parties at the time of the fraudulent representations. Although the general rules relating to pleading and proof of facts excusing a late discovery of fraud remain applicable, it is recognized that in cases involving such a relationship facts which would ordinarily require investigation may not excite suspicion, and that the same degree of diligence is not required. In Rutherford v. Rideout Bank, 11 Cal. 2d 479, 486 [80 P. 2d 978, 117 A. L. R. 383], it was said that because of such a relationship plaintiff could not be charged with lack of diligence even though an inquiry would have disclosed the true value of the property involved. (See, also, Bainbridge v. Stoner, 16 Cal. 2d 423, 430 [106 P. 2d 423]; Knapp v. Knapp, 15 Cal. 2d 237, 242 [100 P. 2d 759]; Lataillade v. Orena, 91 Cal. 565 [27 P. 924, 25 Am. St. Rep. 219]; Laraway v. First Nat. Bk. of La Verne, 39 Cal. App. 2d 718 [104 P. 2d 95]; 12 Cal. Jur. 799; (1942) 30 Cal. L. Rev. 589, 591; *cf.* Marston v. Simpson, 54 Cal. 189; Edward Barron Estate Co. v. Woodruff Co., 163 Cal. 561, 575-577 [126 P. 351, 42 L. R. A. N. S. 125].) Defendants

argue that the fiduciary relationship terminated when the sale was completed and that plaintiff was no longer entitled to the benefit of the rule. *The relationship, nevertheless, did exist at the time of the asserted fraud, and plaintiff was under no duty to make a complete search and re-examination of the entire transaction immediately after it took place merely because the fiduciary relationship between the parties was terminated thereby.* Under these circumstances, it was for the jury to determine whether it was negligence for plaintiff, after completion of the transaction, to continue to rely upon the representations that were made while he was a stockholder. (Italics added.)

"Defendants contend, however, that certain facts indisputably known to plaintiff were sufficient to put him on inquiry. These contentions must be examined in the light of the rule announced in Northwestern P. C. Co. v. Atlantic P. C. Co., 174 Cal. 308, 312 [163 P. 47]. The court there said that when the facts are susceptible to opposing inferences, whether 'a party has notice of "circumstances sufficient to put a prudent man upon inquiry as to a particular fact," and whether "by prosecuting such inquiry, he might have learned such fact" (Civ. Code, Sec. 19), are themselves questions of fact to be determined by the jury or the trial court.' (See, also, West v. Great Western Power Co., 36 Cal. App. 2d 403, 411 [97 P. 2d 1014]; 20 Cal. Jur. 240). The facts mentioned by defendants have been discussed and analyzed heretofore in connection with the contention that the evidence is insufficient to establish either actionable misrepresentation or plaintiff's reasonable reliance thereon, and we shall not repeat them here. Although the jury

could properly have concluded that knowledge of these facts and others urged by defendants should have put a prudent man on inquiry, we are satisfied that none of the matters admittedly known to plaintiff up to and including the time of completion of the transaction compelled such a conclusion as a matter of law.

"The evidence is clearly sufficient to support the implied finding of the jury that plaintiff learned nothing to arouse his suspicions during the period between the completion of the transaction and the alleged discovery of the fraud in 1941. The record shows that plaintiff went to Europe some time in 1936 and remained there until January of 1941, when he returned to New York. He testified that prior to that time he had no information, nor had anything come to his attention, that would make him suspect that he had been 'overreached' in the transaction, or had not received the full value of his stock, or had been defrauded. Although absence from the locality would not toll the statute of limitations if it had already commenced to run (for example, if plaintiff had been put on inquiry by facts known to him prior to his trip to Europe), it was a relevant factor to be considered by the jury in explanation of the delay in discovery. (See Seeger v. Odell, 18 Cal. 2d 409, 418 [115 P. 2d 977, 136 A. L. R. 1291]; cf. Teats v. Caldwell, 28 Cal. App. 206, 210 [151 P. 973].

"Defendants contend, next, that plaintiff has not established sufficient facts relating to the claimed actual discovery of the fraud in 1941. In addition to negativing notice of the fraud and excusing failure to discover it sooner, plaintiff must allege and prove facts showing the time and surrounding cir-

cumstances of the discovery and what the discovery was. (See Davis v. Rite-Lite Sales Co., 8 Cal. 2d 675, 681 [67 P. 2d 1039]; Kelly v. Longan, 5 Cal. 2d 274, 276-277 [53 P. 2d 971]; Consolidated R. & P. Co. v. Scarborough, 216 Cal. 698, 703 [16 P. 2d 268]; Original Min. & Mill. Co. v. Casad, 210 Cal. 71, 75 [290 P. 456]; Victor Oil Co. v. Drum, 184 Cal. 226, 241 [193 P. 243].)

"In applying this rule it is important to recognize the distinction between cases where the plaintiff is under a duty to inquire and those in which he is not obliged to make any investigation until he has notice or knowledge of the happening of some incident or of some fact or facts sufficient to arouse the suspicions of a reasonable person. Where there is a duty to investigate, the plaintiff may be charged with knowledge of the facts which would have been disclosed by an investigation; but where, as here, there is no prior duty to investigate, the statute does not run until he has notice or knowledge of facts sufficient to put a reasonable man on inquiry. The rule that the plaintiff must show what information he has obtained, so that the court may determine whether or not the facts leading to the discovery of the fraud existed for more than three years prior to the commencement of the suit and could have been discovered by the exercise of ordinary diligence, is applicable only where the plaintiff was under a duty to make a diligent inquiry and he seeks to excuse his failure to discover the fraud by showing that the true facts were not then available or that the inquiry he did make was diligent, though unsuccessful. (See Consolidated R. & P. Co. v. Scarborough, 216 Cal. 698, 703-704 [16 P. 2d 268]; *cf.* Phelps v. Grady, 168 Cal. 73, 77-78 [141 P. 926]; Wood v. Carpenter, 101 U. S. 135, 140 [25 L. Ed.

807].) In the absence of a duty to make inquiry, as pointed out above, the statute does not run merely because the means of discovery were available, and plaintiff is not compelled to disprove that such means existed. He need only establish facts sufficient to show that he made an actual discovery of hitherto unknown information within three years before the filing of the action. In the Scarborough case, *supra,* the plaintiff merely showed that, after a lapse of more than the statutory period, an investigation was made which led to discovery of the fraud, but there was no showing of the reasons which prompted the investigation. As the court there pointed out (216 Cal. at p. 704), for all that appeared the plaintiff may have had prior knowledge of the suspicious facts, and there was no showing why an earlier investigation was not made. The requirement that plaintiff show what information he received or what suspicious facts came to his notice is imposed in order that the court may determine whether or not the discovery was made within the time alleged, that is, whether plaintiff actually learned something he did not know before. (Lady Washington C. Co. v. Wood, 113 Cal. 482, 487 [45 P. 809]; Victor Oil Co. v. Drum, 184 Cal. 226, 241 [193 P. 243]; Galusha v. Fraser, 178 Cal. 653, 657 [174 P. 311].) In the Lady Washington case, at page 487, the court said that the plaintiff must 'show the times and the circumstances under which the facts constituting the fraud were brought to his knowledge, *so that the court may determine whether the discovery of these facts was within the time alleged.*' (Italics added.)

"The pleading on this point is sufficient. The amended complaint alleges that plaintiff had no prior knowledge that any fraud had been perpetrated; that in February, 1941, he had a conversation with

a man in New York who informed him that after plaintiff had left for Europe in 1936, Charles Crocker had stated that in the settlement of the will contest Greene and Crocker's lawyer had gotten together and had given plaintiff a 'fearful trimming,' and that, as a part of the settlement of the contest, plaintiff had sold his stock to them for $25 a share when its actual value was at least $120 a share; that about two months thereafter he came to San Francisco and consulted with Aureguy, Harris and his present counsel; and that in the early part of May, 1941, his counsel 'informed him that he had procured information that the Hobart Estate Company was and apparently had been for several years in excellent financial condition and owned numerous valuable properties which were unencumbered.'

"Although the supporting evidence is less detailed than the allegations, it is sufficient to bring plaintiff within the rule above stated. He testified, in substance, that upon his return to New York in January, 1941, he received 'some information . . . or suggestion' from an unidentified person concerning the holdings of the Hobart Estate Company that was at variance with Green's representations; that prior to that time he had no information, nor had anything come to his attention, that would make him suspicious that he had been defrauded; that as soon as he was able to come to San Francisco and consulted Aureguy, Harris and his present counsel; and that he then received information as to the nature and value of the company's holdings, and the status of encumbrances, that was excessively at variance with the statements made to him by Greene. Plaintiff offered no further evidence in support of the allegation regarding the conversation in New York, and it is obvious from the record that his counsel

did not ask him to state the details of the information received, fearing that a recital of what plaintiff learned might be inadmissible hearsay.

"Plaintiff has thus shown that he had no notice or knowledge of any suspicious facts or circumstances prior to January, 1941, that at that time he was first put on notice of possible fraud, and that within six months thereafter he made an investigation, discovered the fraud, and commenced the action. It follows, therefore, that he has brought himself within the exception to subdivision 4 of section 338 of the Code of Civil Procedure and that he is not barred by the statute of limitations."

From the foregoing, we especially stress:

"Although the general rules relating to pleading and proof of facts excusing a late discovery of fraud remain applicable, it is recognized that in cases involving such a relationship, [fiduciary] facts which would ordinarily require investigation may not excite suspicion, and that the same degree of diligence is not required." (P. 440.)

Also:

That is the case here.

" 'The courts will not lightly seize upon some small circumstance to deny relief to a party plainly shown to have been actually defrauded on the ground for sooth, that he did not discover the fact that he had been cheated as soon as he might have done. It is only where the party defrauded should plainly have discovered the fraud except for his own inexcusable inattention that he will be charged with a discovery in advance of actual knowledge on his part.' It follows

> that plaintiff is not barred because the means of discovery were available at an earlier date provided he has shown that he was not put on inquiry by any circumstances known to him or his agent at any time prior to the commencement of the three year period ending June, 1941."

The picture presented here is of a stranger coming from Utah to Calfornia, without knowledge of the California Corporate Securities Act [R. 7-8]. In June of 1947, the Reypo Corporation was desperate for funds. This is obvious from every assertion in the complaint. The corporation then had a permit for the issuance of shares under certain conditions. The defendants "sold" 10,000 shares of the stock to the plaintiff [R. 5-6]. $10,000.00 was paid. *No part of the $10,000.00 was put in the depositary required by the then existing permit to issue stock* [R. 6]. The money was used for corporation purposes [R. 6]. The plaintiff trusted his associates; he accepted the corporate note. *Immediately,* the associates went to work and caused the corporation in June of 1947, to make a new application for a permit to issue stock. This permit was issued in September of 1947, and the Corporation Commissioner permitted the shares to be *issued for cash.* No shares were actually issued until December of 1947, when the plaintiff turned in his note, received the shares of stock and received a "check" [R. 44] for $10,000.00 [R. 44]. He immediately endorsed and returned this "check" to the Reypo Corporation. The Corporation never cashed, never negotiated it. No bank ever cashed it or punched its canceling "PAID" therein.

It is this thinly veiled subterfuge which consummated the fraud.

As to discovery thereof, from the Complaint, Best worked for the corporation first as its sales representative in the field, in fact this was all the active work that he ever did except during the time when he was working in the factory. Otherwise, he became a member of the board of directors in January of 1948, and remained such until November of 1948, when the corporation went through bankruptcy. In December of 1947, he had learned of the precarious financial condition of the corporation and thereafter spent all of his best efforts and his best time in endeavoring to sell his products and thus pull it out of the financial hole that it was in.

Albeit he was a director and secretary-treasurer of the corporation from January to November, 1948, nevertheless it is clear from the complaint that this phase of his activities occupied only a small portion of his time.

A fiduciary relationship existed from the defendants toward plaintiff from the time in June of 1947, when he parted with $10,000.00 until the bankruptcy—at least—for the defendants were corporate directors and he had bought stock.

That he trusted his associates is unquestioned; they were co-directors; all were engaged in a business. All were co-workers with respect to the business, so that the plaintiff at no time had any suspicion that a spurious trick had been played upon him. He was never suspicious as to the application which had been made before the Corporation Commissioner in June of 1947 (simultaneously with his having paid the $10,000.00); in fact, he knew nothing about that application until his attorneys told him about it in the fall of 1951, and he had no reason to suspect its existence.

The first time that he ever received actual custody of the books and records was in November of 1948, when he was instructed by resolution to cause a voluntary petition in bankruptcy to be filed. For the years thereafter until 1951, when he actually discovered the existence of the permit, he was busy trying to rebuild his life. But since the action was filed in October, 1951, we need only inquire back to October, 1948.

It is under these circumstances that the lower court has held that the plaintiff was charged with *constructive knowledge* of the "fact constituting the fraud."

Albeit plaintiff was undoubtedly an officer of the corporation and a director, it is respectfully submitted that his position at all times was such that he was entitled to trust the defendants in this action as his co-directors; that the fiduciary relationship toward him existed when they sold him the stock, and that he was under no duty to plow through the books and records of the corporation looking for some malfeasance on their part, when his full time was occupied trying to put the corporation back upon its financial feet.

"Forsooth he did not discover that he had been cheated as soon as he might have." The lower court's ruling makes diligence no longer a virtue. The plaintiff has spent his time working for the welfare of the defendants who defrauded him. If the ruling of the lower court be allowed to stand he will be punished for such diligence and trust toward his business fiduciaries.

It is submitted under all the circumstances shown in this case by the Second Amended Complaint, that plaintiff Howard Best was not charged constructively with notice, due to the fiduciary relationship which patently existed, and due to his own diligence in prosecuting the welfare of the corporation at the expense of his own individual interest.

The judgment of the lower court and the order dismissing the action should be reversed and the defendants should be held to answer to the Second Amended Complaint.

Respectfully,

GEORGE R. MAURY,

Attorney for Appellant.